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IN REPLY REFER TO
FILE NO.: 933-0197
VIA USPS PRIORITY MAIL

July 16, 2003

FINAL REPORT

Mohender Narula, D.M.D., President
JAIMINI HEALTH, INC.
3350 Shelby Drive, Suite 100
Ontario, CA 91764

RE: ROUTINE EXAMINATION OF JAIMINI HEALTH, INC.

Dear Dr. Narula:

Enclosed is the Final Report of a routine examination of the fiscal and administrative affairs of Jaimini Health, Inc. (the "Plan"), conducted by the Department of Managed Health Care (the "Department"), pursuant to Section 1382 (b) of the Knox-Keene Health Care Plan Act of 1975¹. The Department issued a Preliminary Report to the Plan on April 28, 2003. The Department received the Plan's responses on May 7 and 13, 2003 and on June 16, 2003.

This Final Report includes a description of the compliance efforts included in the Plan's May 7 and 13, 2003 and June 16, 2003 responses, in accordance with Section 1382(c).

Section 1382 (d) states "If requested in writing by the plan, the Director shall append the plan's response to the final report issued pursuant to subdivision (c). The plan may modify its response or statement at any time and provide modified copies to the department for public distribution not later than 10 days from the date of notification from the department that the final report will be made available to the public. The addendum to the response or statement shall also be made available to the public."

Please indicate within ten (10) days whether the Plan requests the Department to append its response to the Final Report. If so, please indicate which portions of the Plan's response shall be appended, and provide copies of those portions of the Plan's response exclusive of information held confidential pursuant to Section 1382(c), no later than ten (10) days from the date of the Plan's receipt of this letter.

¹ References throughout this report to "Section" are sections of the Knox-Keene Health Care Service Plan Act of 1975, California Health and Safety Code Section 1340, *et. Seq.* Reference to "Rule" are to the regulations promulgated pursuant to the Knox-Keene Health Care Service Plan Act, found at Title 28, Division 1, Chapter 1, California Code of Regulations, beginning with Section 1300.43.

If the Plan requests the Department to append a brief statement summarizing the Plan's response to the report or wishes to modify any information provided to the Department in its May 7 and 13, 2003 and June 16, 2003 response to the Preliminary Report, please provide the documentation no later than ten (10) days from the date of the Plan's receipt of this letter.

The Department will make the attached Final Report available to the public in ten (10) days from the Plan's receipt of this letter.

As noted in the attached Final Report, the Plan's responses to the Preliminary Report did not fully respond to the deficiencies raised in the Preliminary Report issued by the Department on April 28, 2003. Pursuant to Rule 1300.82, the Plan is required to submit a response to the Department for any request for additional corrective action contained within the attached Final Report, within 30 days after receipt of the report. If the Plan fails to fully respond and/or resolve the deficiencies raised in the Final Report, then a referral will be made to the Office of Enforcement for appropriate administrative action for any remaining, unresolved deficiencies.

Please send a hardcopy of your response directly to the undersigned. In addition, please file the Plan's response electronically, just as you do for regular licensing filings via the Department's web portal <<http://wp.dmhc.ca.gov/efile>> under subfolder RUXAM and barcode RX004. Do not file an Execution Page of Exhibit E-1 (Summary of Filing). Please note this process is separate from the electronic financial reporting and is for the response to this final report only. Questions or problems related to the electronic transmission of the response should be directed to Angie Rodriguez at (916) 324-9048 or email at arodriguez@dmhc.ca.gov or Ed Cheever at (916) 324-8738 or email at echeever@dmhc.ca.gov. You may also email inquiries to helpfile@dmhc.ca.gov.

The deficiencies raised in the Preliminary Report were serious in nature and include significant repeat deficiencies previously addressed in the Department's Confidential Report of examination dated October 1, 1999 for the period ended July 31, 1998. The Plan (formerly known as Healthdent of California) was under different ownership at the time of the previous examination. The current shareholder's ownership of the Plan was effective January 1, 2001. However, the new shareholder, the Board of Directors and the executive management were responsible for the performance of due diligence to determine the Plan's past compliance with the applicable laws and rules of this regulated entity and were responsible for the Plan's continued compliance.

Due to the seriousness of the deficiencies and repeat deficiencies presented in the Preliminary Report, a referral was made to the Department's Office of Enforcement. As a result of this referral, the Plan entered into a Stipulation Agreement with the Department on May 7, 2003. This Agreement set forth timeframes for the Plan to comply with certain corrective actions required within the Preliminary Report and set forth certain actions to be taken by the Department or the Plan should these timeframes not be met. This Agreement is located on the Department's web site at www.dmhc.ca.gov.

Mohender Narula, D.M.D
Re: Routine Examination of Jaimini Health, Inc.

File No. 933-0197
Page 3

The Executive Summary to the Department's most recent Medical Survey Report is also located at the Department's web site.

If there is any question regarding this report, please contact me.

Sincerely,

Joan Larsen
Supervising Examiner
Office of Health Plan Oversight
Division of Financial Oversight

Cc: Andrew Meyers, Acting Deputy Director, Office of Health Plan Oversight
Mark Wright, Chief, Division of Financial Oversight
Warren Barnes, Chief, Division of Licensing
Marie Beckman, Chief, Division of Plan Surveys
Debra Denton, Assistant Chief Counsel, Enforcement
Kelvin Gee, Examiner
Mabel Wu, Examiner
Mary Jane Genco, Licensing Counsel

DEPARTMENT OF MANAGED HEALTH CARE

REPORT OF ROUTINE EXAMINATION

JAIMINI HEALTH, INC.

FILE NO.: 933-0179

DATE OF FINAL REPORT: July 16, 2003

SUPERVISING EXAMINER: JOAN LARSEN

EXAMINER-IN-CHARGE: MABEL WU

BACKGROUND INFORMATION FOR JAIMINI HEALTH, INC.

Date Plan Licensed:	August 15, 1983
Organizational Structure:	The Plan is wholly owned by Dr. Narula. It is a for-profit organization.
Type of Plan:	The Plan is a specialized health care service plan providing dental services to employer groups and individuals.
Provider Network:	The Plan contracts with a network of dentists. The network dentists are reimbursed with a small fixed fee from Plan and high co-payments from members. The Plan is at risk for a \$50 emergency fee.
Plan Enrollment:	10,354 Enrollees as of May 31, 2003
Service Area:	The Plan provides care in 42 counties that cover all of California's major metropolitan markets including greater Los Angeles, Orange County, Bay Area and San Diego markets.
Date of Last Public Report of Routine Examination:	October 1, 1999

FINAL REORT OF A ROUTINE EXAMINATION OF JAIMINI HEALTH, INC.

This is the Final Report of a routine examination of the fiscal and administrative affairs of Jaimini Health, Inc. ("the Plan"), conducted by the Department of Managed Health Care (the "Department") pursuant to Section 1382(b) of the Knox-Keene Health Care Plan Act of 1975¹. The Department issued a Preliminary Report to the Plan on April 28, 2003. The Department received the Plan's responses on May 13, 2003 and June 16, 2003.

This Final Report includes a description of the compliance efforts included in the Plan's May 13, 2003 and June 16, 2003 responses to the Preliminary Report, in accordance with Section 1382(c).

We examined the financial report filed with the Department for the month ended August 31, 2002 as well as other selected accounting records and controls related to the Plan's various fiscal and administrative transactions. Our findings are presented in this report

Section I.	Financial Report and Explanation of Adjustments
Section II	Calculation of Tangible Net Equity
Section III	Tangible Net Equity and Financial Viability
Section IV	Compliance Issues
Section V	Internal Control

Pursuant to Rule 1300.82, the Plan is required to submit a response to the Department for any requests for additional corrective action contained within this report, within 30 days after receipt of this report. If the Plan fails to fully respond and/or resolve the deficiencies noted in the Final Report, then a referral will be made to the Office of Enforcement for appropriate administrative action for any remaining, unresolved deficiencies.

¹ Reference throughout this report to "Section" are to sections of the Knox-Keene Health Care Service Plan Act of 1975, California Health and Safety Code Section 1340, *et. Seq.* References to "Rule" are to the regulations promulgated pursuant to the Knox-Keene Health Care Service Plan Act, found at Title 28, Division 1, Chapter 1, California Code of Regulations, beginning with Section 1300.43.

SECTION I. FINANCIAL REPORT AND EXPLANATION OF ADJUSTMENTS

A. BALANCE SHEET – AS OF AUGUST 31, 2002

	Reported Per F/S @ 08/31/02	Examination Adjustments		Examination Balance @ 08/31/02
		Debit	Credit	
<u>CURRENT ASSETS</u>				
Cash & Cash Equivalent	1,894			1,894
Premiums Receivable	2,369			2,369
Prepaid Expenses	46,584		A1 15,627	
		A5 8,555		
			R1 17,835	21,677
Unsecured Affiliate Receivable	0	R1 17,835		
		R5 23,176		41,011
Aggregate Write-Ins - Current	2,898			2,898
<u>TOTAL CURRENT ASSETS</u>	<u>53,745</u>	<u>49,566</u>	<u>33,462</u>	<u>69,849</u>
<u>OTHER ASSETS</u>				
Restricted Assets	50,000			50,000
Intangible Assets and Goodwill	340,970	R2 130,478	A2 7,637	463,811
<u>TOTAL OTHER ASSETS</u>	<u>390,970</u>	<u>130,478</u>	<u>7,637</u>	<u>513,811</u>
<u>PROPERTY & EQUIPMENT</u>				
Furniture & Equipment - Net	199,555		R2 130,478	
			R3 31,163	37,914
Computer Equipment - Net	0	R3 31,163		31,163
<u>TOTAL PROPERTY & EQUIP</u>	<u>199,555</u>	<u>31,163</u>	<u>161,641</u>	<u>69,077</u>
<u>TOTAL ASSETS</u>	<u>\$644,270</u>	<u>\$211,207</u>	<u>\$202,740</u>	<u>\$652,737</u>

**THIS FINANCIAL REPORT IS NOT ADJUSTED FOR ANY TAX EFFECT RESULTING
FROM THE EXAMINATION ADJUSTING JOURNAL ENTRIES**

A. BALANCE SHEET AS OF AUGUST 31, 2002 (continue)

	Reported per F/S @ 08/31/02		Examination Adjustments Debit	Credit	Examination Balance @ 08/31/02
<u>CURRENT LIABILITIES</u>					
Trade Accounts Payable	\$ 42,984	R4	\$ 33,229	R5 \$ 23,176 A4 18,113	\$ 51,044
Capitation Payable	0			R6 6,553	6,553
Unearned Premium	164,225			A3 110,389	274,614
Aggregate Write-Ins	18,600	R6	6,553		12,047
<u>TOTAL CURRENT LIABILITIES</u>	<u>225,809</u>		<u>39,782</u>	<u>158,231</u>	<u>344,258</u>
<u>OTHER LIABILITIES</u>					
Loans and Notes Payable (Subordinated)	513,500				513,500
Accrued Subordinated Interest Payable				R4 33,229	33,229
<u>TOTAL OTHER LIABILITIES</u>	<u>513,500</u>			<u>33,229</u>	<u>546,729</u>
<u>TOTAL LIABILITIES</u>	<u>739,309</u>		<u>39,782</u>	<u>191,460</u>	<u>890,987</u>
Common Stock	2,000				2,000
Paid In Surplus	87,291				87,291
Retained Earnings (Deficit)	(184,330)				(184,330)
Exam Adjustment from Sec. I.B			151,766	8,555	(143,211)
<u>TOTAL NET WORTH</u>	<u>(95,039)</u>		<u>151,766</u>	<u>8,555</u>	<u>(238,250)</u>
<u>TOTAL LIAB. & NET WORTH</u>	<u>\$644,270</u>		<u>\$191,548</u>	<u>\$200,015</u>	<u>\$652,737</u>

**THIS FINANCIAL REPORT IS NOT ADJUSTED FOR ANY TAX EFFECT RESULTING FROM
THE EXAMINATION ADJUSTING JOURNAL ENTRIES**

**B. STATEMENT OF INCOME AND EXPENSES FOR THE MONTH ENDED
AUGUST 31, 2002**

	Balance per F/S @ 08/31/02		Examination Adjustments Debit	Credit	Balance per Exam @ 08/31/02
Premium	73,456	A3	5,000		
			3,357		
			1,413		
			18,107		
			82,512		(36,933)
TOTAL REVENUE	73,456		110,389		(36,933)
EXPENSES					
Primary Professional Services - Capitated	22,879		A5	\$ 8,555	14,324
Other Medical Professional Services – Capitated	10,278				10,278
Aggregate Write-Ins for Other Medical & Hospital Expenses	5,479				5,479
TOTAL MED & HOSP EXP	38,636			8,555	30,081
ADMINISTRATION					
Compensation	11,577				11,577
Interest Expense	2,696				2,696
Occupancy, Depreciation & Amortization	1,764				1,764
Marketing	8,140				8,140
Aggregate Write-Ins for Other Administration	14,460	A1	15,627		
		A2	7,637		
		A4	18,113		55,837
TOTAL ADMINISTRATION	38,637		41,377		80,014
TOTAL EXPENSES	77,273		41,377	8,555	110,095
OPERATING INCOME (LOSS)	(3,817)		151,766	8,555	(147,028)
Provision for Taxes	66				0
NET INCOME (LOSS)	(3,883)		*151,766	*8,555	(147,028)

*To Section I-A Balance Sheet

**THIS FINANCIAL REPORT IS NOT ADJUSTED FOR ANY TAX EFFECT RESULTING
FROM THE EXAMINATION ADJUSTING JOURNAL ENTRIES**

C. EXPLANATION OF EXAMINATION ADJUSTMENTS

ADJUSTING JOURNAL ENTRIES

<u>AJE#</u>	<u>ACCOUNT NAME</u>	<u>DEBIT</u>	<u>CREDIT</u>
A1	Administrative Expense	\$ 15,627	
	Prepaid DMHC Assessment		\$ 15,627

To write off prior year's DMHC annual assessment as fully amortized at June 30, 2002.

A2	Administrative Expense	\$ 7,637	
	Organization Costs		\$ 7,637

To write off organization cost that should be expensed during period incurred.

A3	Premium Revenue – plan 205	\$ 5,000	
	Premium Revenue – plan 106	\$ 3,357	
	Premium Revenue – plan 205	\$ 1,413	
	Premium Revenue – plan 315	\$18,107	
	Premium Revenue – Primecare	\$82,512	
	Unearned Premium Revenue		\$110,389

To properly recognize as unearned premium revenue those premiums received August 31, 2002 and prior for dates of coverage beginning September 2002 and future.

A4	Administrative Expense	\$18,113	
	Trade Payable		\$ 18,113

To properly accrue for legal expenses and 2001 audit fees that were incurred prior to August 31, 2002, but not yet paid.

A5	Prepaid Capitation	\$ 8,555	
	Primary Professional Services –Capitated		\$ 8,555

To properly recognize as prepaid capitation those capitation payments made to the providers on an annualized basis at August 31, 2002, which are for dates of services to be provided beginning September 2002 and future.

RECLASSIFYING JOURNAL ENTRIES

<u>RJE#</u>	<u>ACCOUNT NAME</u>	<u>DEBIT</u>	<u>CREDIT</u>
R1	Unsecured Affiliate Receivable	\$ 17,835	
	Prepaid Expense		\$ 17,835

To reclassify prepaid rent payments made by the Plan on behalf of Dr. Narula for his other business, as a receivable owed to the Plan.

R2	Intangible Asset	\$130,478	
	Furniture & Equipment		\$130,478

To reallocate the purchased price of Healthdent of California, Inc. for Furniture & Fixtures as an Intangible Asset, based on balance reported by the Plan's independent CPA's for the year ended December 31, 2001. CPA audit adjustment was not made by the Plan.

R3	Computer Equipment	\$ 31,163	
	Furniture & Equipment		\$ 31,163

To reclassify computer equipment to the appropriate line item on the DMHC financial statements.

R4	Trade Payable	\$ 33,229	
	Accrued Subordinated Interest Payable		\$ 33,229

To reclassify subordinated interest payable that was incorrectly classified as Trade Payable.

R5	Unsecured Affiliate Receivable	\$ 23,176	
	Trade Payable		\$ 23,176

To reclassify payments made by the Plan on behalf the President/sole shareholder, as a receivable owed to the Plan instead of an offset to the Trade Payable account.

R6	Aggregate Other Liability	\$ 6,553	
	Capitation Payable		\$ 6,553

To reclassify capitation payable to appropriate line item on the DMHC financial statements.

The Preliminary Report required the Plan to provide written assurance that these adjusting journal entries and reclassifying journal entries were posted to the Plan's books and records, or provide an explanation regarding their disposition.

The Plan responded that it revised its accounts to reflect the above adjusting and reclassifying journal entries. Additionally, the Plan responded that its accounts reflect the adjusting and reclassifying journal entries requested of its outside auditors.

The Department finds that the compliance effort described above is responsive to the corrective action required.

Section II. CALCULATION OF TANGIBLE NET EQUITY ("TNE")—Repeat Deficiency

Net Worth per Examination at August 31, 2002 (from Section I)	\$ <238,250>
Add: Subordinated Debt	546,729
Less: Unsecured Affiliate Receivables	<41,011>
Intangible Assets and Goodwill	<u><463,811></u>
TNE Position at August 31, 2002	<196,343>
Required TNE	<u><50,000></u>
TNE DEFICIENCY at August 31, 2002	<u><u>\$ <246,343></u></u>

The Plan is in violation of Rule 1300.76 that requires each plan to maintain TNE at least equal to the specified minimum amounts at all times.

The Plan's failure to comply with the TNE requirement of Rule 1300.76 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to confirm, within five (5) working days after receipt of this report, that the TNE deficiency of \$246,343 at August 31, 2002 was corrected. All applicable documentation necessary to provide sufficient evidence that the deficiency was corrected was to be submitted.

Although Section 1382 provides for a forty-five (45) working day response for the purpose of confidentiality, due to the significance of this noncompliance a timelier response was warranted. Therefore, a response to Section II. was required within five (5) working days after receipt of the Preliminary Report.

The Preliminary Report also required the Plan to describe the procedures implemented to assure the Department that the Plan will maintain adequate TNE at all times as required by Rule 1300.76. In addition, the Plan was to state the date of implementation of the procedures, the responsible management position, and a description of the monitoring system implemented to ensure ongoing compliance with the corrective action.

The Preliminary Report acknowledged receipt of an original amendment filing on December 18, 2002 and subsequent filings through April 23, 2003, from the Plan in its effort to correct the above TNE deficiency through the transfer of a building from the President and sole shareholder to the Plan.

In order for the Department to complete the review of these filings, the Plan was required to submit the following:

1. An appraisal of the property, by a licensed appraiser.
2. An Owners Title Policy.
3. Documentation of methodology for determining the value of the asset to be recorded to the books of the Plan.
4. Disclosure and documentation of all liens on the property and the party(s) responsible for payment of these liens.
5. Disclosure as to the transfer to the Plan of any related liabilities to this property.
6. Adjusting journal entry to be made by the Plan's independent CPA's for the recording of this asset and any related liabilities to the books of the Plan.
7. Date of recording the asset to the Plan's books and records.

The Plan's May 7, 2003 response included a copy of an appraisal. The Plan's June 16, 2003 response included the original title policy dated July 24, 2002 and an endorsement to name the Plan as the insured under the title policy was dated May 28, 2003. The Plan stated that its independent CPAs recorded the asset contributed to the Plan at its fair market value based on the appraised value of \$1,460,000. The Plan represented that other than liens for general and special taxes and assessments imposed every year, utility, right of way and access and parking easements, the only lien is the deed of trust in favor of Pacific Western National Bank for \$1,012,500. In addition, the Plan disclosed that it has entered a Lease with Dr. Narula, as the Lessee, whereby Dr. Narula is responsible for all liabilities typically incident to ownership, use and possession of property. The Plan represents that the Lease was provided to the Department and is being amended so that the Lessee shall pay cash rent in the amount of the mortgage payment due on the property directly to the Plan. The Plan will recognize rental income on a monthly basis and recognize the payment of the principal and interest on the mortgage. The Plan provided the monthly journal entries to be recorded to the Plans general ledger. The Plan also provided the journal entry to record the property, related liability and resulting "paid in capital" of \$447,500. The Plan represents that this property was recorded as an asset on December 10, 2002, the date of the quitclaim deed.

The Plan stated that the Department was made aware that in May of 2003, the Plan's shareholder, Dr. Narula, contributed an additional \$25,000 to the Plan.

The Department finds that the compliance effort described above is responsive to the corrective action required. The Department reviewed the documentation as provided in the Plan's response and finds that the Plan is in compliance with Rule 1300.76, as the Plan reports excess TNE of \$ 263,133 at May 31, 2003.

The Department notes that the Preliminary Report did not clearly indicate that items 1 to 7 of the Plan's response were to be filed as an amendment filing to supplement the Plan's original amendment filing of December 18, 2002. On July 2, 2003, the Department made a verbal request for the Plan to electronically file this documentation as an amendment by July 8, 2003. The Department received this amendment filing on July 16, 2003.

The Plan references above that the Lease arrangement between the Plan and Dr. Narula was filed with the Department. The Department has no record of receiving this agreement. **The Plan is required to file a hardcopy with its response to this report.**

SECTION III. TANGIBLE NET EQUITY AND FINANCIAL VIABILITY

A. TANGIBLE NET EQUITY (TNE)

Section 1376 states that each plan shall have and maintain TNE equal to an amount that is calculated based upon requirements set forth in Rule 1300.76. Rule 1300.76(e) states that the required amount of TNE must be maintained at all times. Rule 1300.76(a) also sets forth the method for determining the required amount of TNE that shall be maintained at all times.

The Plan incorrectly reported excess TNE of \$27,491 in its financial statement filings made with the Department for the month ended August 31, 2002, due to the following:

- ?? Furniture and Equipment was significantly overstated as a result of an unsupported allocation of the purchase price of Healthdent of California, Inc. ("Healthdent") by the Plan. The Plan's independent CPA reclassified the overstatement to intangible assets at the year ended December 31, 2001. However, the Plan has not recorded this adjustment to its books to date. [See Section I. C. reclassification entry R2.]
- ?? Assets were over accrued, liabilities were under accrued and revenues were overstated due to the Plan's failure to maintain its books and records on an accrual basis in accordance with Generally Accepted Accounting Principles ("GAAP"). See Section I. of this report for numerous adjusting and reclassifying entries necessary to properly state the Plan's interim financial position. [See Section IV.C. of this report for related comments.]
- ?? Payments made by the Plan on behalf of the President and sole shareholder for non-Plan related activities were improperly reported by the Plan as either a prepaid expense or offset against the trade payable account, instead of being reported as an Unsecured Affiliate Receivable. This receivable was not in the normal course of business and was not adequately secured by tangible assets. Therefore, it must be excluded in calculating the Plan's TNE position. *These types of transactions must stop immediately.* [Reference to Rule 1300.76(e)]
- ?? Subordinated interest payable was improperly recorded to the Plan's trade payable account to offset the receivables from the President and sole shareholder that were also improperly recorded as a reduction to the trade payable account. Due to the Plan's subordination agreement and the fact that the Plan has a TNE deficiency, the Plan is not obligated to pay principal or interest on the note payable to stockholder. Therefore, subordinated interest payable is to be accrued as a liability and may be added back in calculating the Plan's TNE position.

The Department issued a letter dated November 15, 2002 to the Plan that **rejected** the annual financial statements for the year ended December 31, 2001, pursuant to Section 1384(h). This letter also addressed the above concern regarding the variances in values assigned to Intangible Assets and Furniture and Equipment between the Plan's audited financial statements for the year ended December 31, 2001 and the Plan's DMHC financial statement format for the same period. As a result of these variances, the Plan's TNE calculation was incorrectly reported as \$18,494 in excess TNE at December 31, 2001, when in fact it was a TNE deficiency of <\$127,193>. To date, the Plan has not responded to certain corrective actions required by the Department in this letter. Therefore, the Department has repeated some of the same corrective actions below.

Due to the deficiencies cited above and the resulting impact on the Plan's TNE compliance, the Preliminary Report required the Plan to file revised DMHC Financial Reporting Forms and related TNE calculations for the calendar year ended December 31, 2001, the quarters ended March 31, 2002 through December 31, 2002 and the months ended January and February 2003. These submissions were to be labeled "revised". These revised financial statements were to reflect the independent CPA's audit adjustments for the year ended December 31, 2001; reflect the proper presentation of all accounts in accordance with GAAP (such as adjusting and reclassification entries in Section I. of this report); properly report subordinated debt/interest and unsecured affiliate receivables. The supplemental information to accompany these reports was to be revised to include the proper calculation of the required TNE pursuant to Rule 1300.76. The Plan may include a footnote reference regarding the corrective action taken to correct the resulting TNE deficiencies. These revised statements were to be submitted electronically to the Department within forty-five (45) days after receipt of the Preliminary Report.

The Preliminary Report also required the Plan to submit a copy of the independent CPA's audit adjustments as of December 31, 2001 and to have their independent CPA file revised audited financial statements for December 31, 2001 that either (1) omit "Schedule I – Computation of Tangible Net Equity" from their report or (2) properly calculate the Plan's TNE in accordance with Rule 1300.76. The revised audited financial statements were to be submitted electronically to the Department within forty-five (45) days after receipt of the Preliminary Report.

The Plan represented that it filed the "revised" DMHC Financial Reporting Forms and related TNE calculations for the calendar year ended December 31, 2001, the quarters ended March 31, 2002 through December 31, 2002 and the months ended January and February 2003. In addition, the Plan stated it filed the required financial reports for the months ended March and April 2003. The Plan stated that these reports reflect the correct calculation of TNE pursuant to Rule 1300.76. The Plan further represented that in the future the CFO, Eric Kalter, CPA, will review all financial information submitted to the Department, including the monthly, quarterly and annual financial reports.

The Plan included in its response revised financial statements for December 31, 2001 and 2002 prepared by Hutchinson and Bloodgood LLP. As noted in the revised December 31, 2001 audited financial statements, the Plan's TNE as of that date is a negative \$127,193 and a positive \$236,346 on December 31, 2002. The Plan represented that it would file the revised financial statements by June 16, 2003.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The Plan did not submit a copy of the independent CPA's audit adjustments as of December 31, 2001. The Plan is again required to do so.

The Department acknowledges receipt of the revised quarterly financial statements on June 16 and 18, 2003. The Department informed the Plan on July 2, 2003 that the revised Audited financial statements for December 31, 2001 and the revised monthly reports for January and February 2003 had not been electronically filed with the Department. The Department

acknowledges receipt of the revised monthly reports on July 5, 2003 and the revised audited report on July 8, 2003.

B. FINANCIAL VIABILITY--Repeat Deficiency

Section 1375.1 requires every licensed plan to demonstrate that it has a fiscally sound operation and adequate provision against the risk of insolvency. Rule 1300.75.1 requires that every plan demonstrate fiscal soundness and assumption of full financial risk through its history of operations, projections, provide for the achievement and maintenance of a positive cash flow, including provision for retirement of existing and proposed indebtedness, and adequate working capital, including provision for contingencies.

The Department has concerns regarding the Plan's ability to demonstrate a fiscally sound operation and adequate provision against the risk of insolvency, as follows:

1. As presented in Section II. of this report, the Plan suffers a TNE deficit of <\$246,343>.
2. The Plan failed to maintain adequate working capital. The Department determined that the Plan's current assets are not adequate to cover the Plan's current liabilities, as follows:

	Month Ended <u>8/31/02¹</u>	Quarter Ended <u>9/30/02²</u>	Quarter ended <u>12/31/02</u>	Month Ended <u>1/31/03</u>	Month Ended <u>2/28/03</u>
Current Assets	\$ 69,849	58,631	50,063	51,738	58,246
Less:					
Current Liabilities	344,258	234,865	231,772	217,319	217,621
Excess <Deficit> Working Capital	<u><274,409></u>	<u><176,234></u>	<u><181,709></u>	<u><165,581></u>	<u><159,375></u>
Current Ratio	.20:1	.25:1	.22:1	.24:1	.27:1

3. The Plan failed to maintain sufficient cash to cover its current obligations, as presented below. The most recent financial reports filed by the Plan for the quarter ended December 31, 2002 through the month ended February 28, 2003 disclose "zero" cash balances with bank overdrafts reported within the current liabilities.

¹ As presented in Section I of this report.

² The financial statements referenced for time periods after August 31, 2002 were filed directly by the Plan with the Department without effect of examination adjustments presented in Section I. This report.

	Month Ended <u>8/31/02</u>	Quarter Ended <u>9/30/02</u>	Quarter Ended <u>12/31/02</u>	Month Ended <u>1/31/03</u>	Month Ended <u>2/28/03</u>
Cash	\$ 1,894	4,217	0	0	0
Less:					
Bank Overdraft	0	0	7,431	4,089	13,327
Other Current Liabilities	344,258	234,865	224,341	213,230	204,294
Excess <Deficit> Cash Over Current Liabilities	<u>\$ <342,364></u>	<u><230,648></u>	<u><231,772></u>	<u><217,319></u>	<u><217,621></u>

4. The Plan failed to demonstrate an ability to generate cash from operations, as it has not achieved positive cash flows from operations, as follows:

	Month Ended <u>8/31/02³</u>	Quarter Ended <u>9/30/02</u>	Quarter Ended <u>12/31/02</u>	Month Ended <u>1/31/03</u>	Month Ended <u>2/28/03</u>
Cash Flow Provided <used> in Operating Activities	\$ <5,099>	<4,969>	<45,648>	<11,658>	<16,238>

5. The Plan has failed to achieve profitable operations, as presented below. Our review of the Plan's historical financial statement filings with the Department indicate that the Plan has suffered losses in all quarters since it started operations on January 1, 2001.

	Year Ended <u>12/31/01⁴</u>	Eight Months Ended <u>8/31/02</u>	Quarter Ended <u>9/30/02</u>	Quarter Ended <u>12/31/02</u>	Month Ended <u>1/31/03</u>	Month Ended <u>2/28/03</u>
Net Income <Loss>	\$ <184,317>	<147,028>	<17,349>	<56,123>	<4,421>	<6,342>

6. As reported by the Plan, enrollment has significantly decreased, as follows:

	Quarter Ended <u>3/31/02</u>	Month Ended <u>8/31/02</u>	Quarter Ended <u>9/30/02</u>	Quarter Ended <u>12/31/02</u>	Month Ended <u>1/31/03</u>	Month Ended <u>2/28/03</u>
Enrollees	15,886	15,016	12,622	11,847	11,118	11,033

³ As reported by the Plan

⁴ As reported in Plan's annual audited report.

7. The Plan has failed to pay the providers under the PrimeCare product in accordance with their contract. Capitation payments for July and August 2002 dates of service were not made by the Plan until October 2002. These payments should have been made during August and September 2002, respectively. As of January 31, 2003, the Plan had accrued a liability, but failed to pay these providers capitation for September, October, November and December 2002 months of service.
8. The Plan's quarterly financial report for December 31, 2002 includes Schedule F that provides an aging schedule of the Plan's Accounts Payable for creditors having balances greater than 5% of total trade accounts payable. This report states that the majority of these balances (total of \$19,295) are more than 90 days past due.
9. The Plan does not prepare annual budgets or forecasts on a routine basis that would provide goals for achieving financial viability through growth of enrollment and the financial performance of the Plan.

The Department's concerns regarding fiscal viability were previously addressed with the Plan in a letter dated November 15, 2002 issued by Richard Martin, Supervising Examiner and a follow-up letter dated January 15, 2003 issued by Kelvin Gee, Examiner. The Plan filed its corrective action plan with the Department on March 12, 2003, which is currently under review.

The Department received an original amendment filing on December 18, 2002 regarding a transfer of assets in the form of real estate to the Plan from its sole shareholder. While this transaction may potentially correct the TNE deficiency, the Department notes that the infusion of real estate will not improve the Plan's cash position or the financial viability concerns addressed above.

The Department also acknowledged that the Plan's President and sole shareholder filed a Guaranty Agreement, executed on November 8, 2002, with the Department on January 6, 2003. This agreement guarantees that the owner shall contribute capital sufficient to ensure that TNE is maintained at the required level. However, this guarantee provides no evidence of the owner's ability or willingness to provide funding at the levels necessary to meet the Plan's ongoing cash needs.

As noted above, the Plan is not generating the net income or positive cash flows needed to sustain an on-going, financially viable operation. Therefore, the Department has serious concerns regarding the Plan's continued ability to operate.

The Plan's failure to comply with the financial viability requirements of Section 1375.1 and Rule 1300.75 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to provide a corrective action plan that would result in an adequate demonstration of financial viability with specific disclosure as to the steps taken to improve its cash/liquidity position. This demonstration must include the changes made, the

procedures put in place, and the management position responsible for ensuring fiscal soundness and compliance with Section 1375.1 and Rule 1300.75.1 at all times. The Plan's response shall include, but not be limited to, the cash management policies and procedures for the Plan.

The Plan represented that it's CEO and President, Dr. Narula, has taken significant and serious steps to correct the financial problems that were identified during the financial examination exit interview of April 18, 2003. The Plan stated that among the corrective actions taken was the retention of Eric Kalter, CPA, as the Plan's CFO and a member of the Plan's Board of Directors. Mr. Kalter's background includes providing expert accounting consultation to various other health care service plans. The Plan stated that it would file Mr. Kalter's Individual Information Form by June 16, 2003. As CFO, Mr. Kalter will report to the Plan's CEO and he has implemented the following changes:

- (a) weekly cash report.*
- (b) review of monthly, quarterly and annual financial reports filed with the Department.*
- (c) retention of a seasoned HMO marketing person.*
- (e) consolidation of operations into the Plan's Ontario office.*
- (f) reduction of duplicative staff and reduction in hours of staff, when appropriate.*

The Plan also represented the following:

?? that \$25,000 in funding was provided by the shareholder during May 2003;

?? the weekly cash report is reviewed by CEO and additional cash is immediately contributed, if needed;

?? the duties and responsibilities of the COO were transferred to the CEO; and,

?? that the President and CEO of the Plan is responsible to ensure the fiscal soundness and compliance of the Plan with Section 1375.2 and Rule 300.75.1.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The Plan did not provide the cash management policies and procedures within the corrective action plan for the improvement of its cash/liquidity position. The Plan is again required to provide this documentation.

In addition, the Preliminary Report required the Plan to provide a detailed business plan that outlines each management initiative undertaken to improve its operational performance. The business plan was to include the specific dollar amount related to or to be achieved by

implementing each management initiative, the date as to when each management initiative was or will be implemented, and the date of completion or milestone reached for each initiative.

The Plan provided, as an attachment to its response, a summary of changes to the Plan's operations that identified the following management initiatives undertaken to improve its operational performance: retention of a seasoned HMO marketing person; consolidation of operations into the Plan's Ontario office; reduction of duplicative staff; elimination of COO position and transfer of those duties to CEO; and reconstruction of the Board of Directors. The Plan included the specific dollar amount related to or to be achieved by implementing each management initiative. The Plan represented that the date as to when each management initiative was or will be implemented, and the date of completion or milestone reached for each initiative was presented in this business plan. The attachment also included a detailed business plan that sets forth the Vision Statement, Company Overview, Company History, Company Organization, Industry Overview, Competitive Climate, Marketing Strategy, and Products/Services.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The summary of changes the Plan provided that outlines each management initiative undertaken to improve its operational performance did not include the date as to when each management initiative was or will be implemented, and the date of completion or milestone reached for each initiative as represented by the Plan. The Plan is again required to provide this documentation.

Furthermore, the Preliminary Report required the Plan to file financial projections on a monthly basis for one year or until breakeven, whichever is later, and on a quarterly basis for an additional year. These projections must include a balance sheet; statement of income and expense, statement of cash flows prepared in accordance with generally accepted accounting principles. They should also include enrollment information, capital funding needs, affiliate transactions, TNE and administrative cost calculations for each month and quarter presented. These projections should be accompanied by all assumptions which are necessary to support the projections, including a description of the marketing program and documentation of all sources of capital funding needed to ensure compliance with the TNE requirements of Rule 1300.76 at all times.

The Preliminary Report required the Plan to identify the cash funding needed to reach breakeven and to maintain operating expenses on a current basis. The cash funding must be contributed to the Plan within forty-five (45) days after receipt of the Preliminary Report. The Plan was also required to provide documentation that the Plan received this funding.

The Preliminary Report required the projections to begin with the historical financial statements for the quarter ended December 31, 2002, as revised pursuant to the request under Section III. A. of this report, and should be based upon and agree with these statements. The projections should also reflect the management initiatives request above, the adjusting journal and reclassification entries noted in Section I. of this report.

The Plan included, as an attachment to its response, financial projections on a monthly basis for May 2003 through April 2004 and on a monthly basis for one additional year. The projections included a balance sheet; statement of income and expense; and, statement of cash flows. The Plan represented that these statements were prepared in accordance with generally accepted accounting principles. The Plan stated that the projections also included enrollment information, capital funding needs, affiliate transactions, and administrative cost calculations for each month presented. The Plan represented that the projections were accompanied by detailed assumptions which are necessary to support the projections, including a description of the marketing program and documentation of all sources of capital funding needed to ensure compliance with the TNE requirements of Rule 1300.76 at all times. The Plan further stated that its TNE is four times more than the required amount.

The Plan included financial projections within its response and stated that the financial statements contain the cash funding needed to reach breakeven and to maintain operating expenses on a current basis. The Plan represented that it does not anticipate additional funding required of its shareholders; however, as noted in the CAP related to cash/liquidity issues, the Plan monitors its cash position on a weekly basis. If after its review it is determined additional cash is required, the Plan's shareholder will immediately contribute the additional funding to the Plan.

The Plan responded that the projections, included in its response, commence as of May 1, 2003, and are based upon and agree with the "revised" actual financial information of December 31, 2002.

The Department finds that the compliance effort described above and the financial projections provided within the Plan's response do not demonstrate substantial compliance with the financial viability requirements, as follows:

- ?? The financial projections did not consider the more current historical financial statements for the quarter ended March 31, 2003 or month ended April 30, 2003, which reflect net losses of \$20,484 and \$16,114, respectively. As a result, the projections present much lower net losses than actually incurred in the most current period. The projected net loss for May 31, 2003 was \$1,931 compared to the actual net loss of \$27,224 as reported to the Department for the month ended May 31, 2003. The Plan's financial projections present breakeven at month ending December 31, 2003. However, if actual losses continue at a higher amount than disclosed in the projections, then the breakeven point may be further out than projected.
- ?? The financial projections do not demonstrate the achievement of positive working capital through the two-year period projected to April 2005. The Plan's actual financial statement for May 31, 2003 reports current assets of \$53,522, which are not adequate to cover the current liabilities of \$312,899 and results in negative working capital of <\$259,377>. The current ratio at May 31, 2003 has decreased to .17:1. The Plan's

negative working capital is actually greater, as the mortgage loan of \$1,035,489 at May 31, 2003 should be considered a current liability due to the loan being payable on demand. The projections do not present the entire mortgage loan as a current liability. The footnotes to the annual audited report for December 31, 2002, state that this loan is payable on demand and is to be classified as a current liability.

- ?? The financial projections do not demonstrate the maintenance of sufficient cash to cover its current obligations throughout the two-year period projected to April 2005. The Plan's actual financial statement for May 31, 2003 reports cash of \$37,307, which is not adequate to cover the current liabilities of \$312,899 (or \$1,348,388 with the mortgage loan included).
- ?? The enrollment projections demonstrate continued loss of enrollment through September 2003 with a 9% increase by December 31, 2003. The enrollment projections were not accompanied by assumptions or statistical/historical data to support the monthly growth in enrollment. The Plan reported enrollment of 10,354 at month ended May 31, 2003, which is higher than the projected enrollment of 10,221 for this projected month.
- ?? The description of the marketing program provided within the Plan's response differs from the proposed marketing strategy recently shared with the Department in our weekly meetings to monitor the Plan's progress. The projections do not consider the proposed marketing strategy. Solicitation for new enrollment under this proposal is not anticipated to begin until about September 2003.
- ?? The per member per month premium amount and related dental capitation and commission expenses were not accompanied by assumptions to support the amounts and/or percentages used in the projections. The methodology for developing these charges should be supported by either actuarial or historical data.
- ?? The projected dental service costs include commission paid to the dentists as a "medical cost". All costs incurred in the solicitation of subscribers and enrollees are considered administrative costs pursuant to Rule 1300.78. The projections do not include the administrative cost percentages for each period. The Plan's administrative costs continue to be excessive (Section 1378/Rule 1300.78).

Due to the Department's serious concerns regarding the Plan's continued ability to operate, as disclosed in the Preliminary Report, a referral was made to the Office of Enforcement. The Plan and the Department entered into a Stipulation on May 7, 2003 that set forth, in part, the following regarding the Plan's compliance with the duties and obligations set forth in the Preliminary Report:

1. The Plan is to be substantially in compliance on or about September 1, 2003 or the Department may exercise its authority to issue an Order to freeze the plan's enrollment.

2. The Plan is to be in compliance on or before November 1, 2003 or the Plan will file an application for surrender with the Department on or before November 15, 2003.

The Department continues to have serious concerns regarding the Plan's ability to comply with these timeframes based on the Plan's corrective action presented in its June 16, 2003 response to the Preliminary Report as to Financial Viability, and in the information shared with the Department in the weekly meetings that have taken place since May 7, 2003.

Therefore, the Plan is again required to demonstrate the immediate corrective action taken to bring the Plan into compliance with the financial viability requirements. This corrective action may include, but is not limited to, the infusion of cash to reach breakeven and to achieve and maintain positive working capital for operational purposes. Revised projections that begin with the historical financial statements for the month ended May 31, 2003 and demonstrate compliance with the above bullet points should be included as additional support in the Plan's demonstration of compliance.

Section IV. COMPLIANCE ISSUES

A. ADMINISTRATIVE CAPACITY—*Repeat Deficiency*

Section 1367(g) requires a plan to have the organizational and administrative capacity to provide services to subscribers and enrollees. Rule 1300.67.3(a)(2) and (3) requires the plan to have staffing in fiscal and administrative services sufficient to result in the effective conduct of the plan's business and to have written procedures for the conduct of the business of the plan so as to provide effective controls.

To demonstrate adequate administrative capacity, a plan must have an executive staff and support staff, sufficient to perform the necessary functions of a health care service plan. A plan may make contractual arrangements for non-discretionary or ministerial services, but any function that requires the exercise of any judgment, decision-making or discretion must be performed by plan staff and with plan management retaining ultimate responsibility. Also, the responsibility for the day-to-day functions and the oversight of any delegated function must reside with plan management.

Our examination disclosed that the Plan did not have administrative capacity as required by Section 1367(g) and Rule 1300.67.3(a)(2) and (3). The deficiencies noted throughout this report demonstrate the lack of understanding by the Plan of its obligations to comply with the financial and compliance requirements placed on the Plan by the Knox-Keene Health Care Service Plan Act of 1975 and the California Code of Regulations.

The following are examples of the Plan's lack of administrative capacity:

1. Our examination disclosed that the Chief Financial Officer (the "CFO") and Senior Accountant are consultants to the Plan and perform accounting functions on behalf of the Plan without benefit of a written consulting contract (or administrative services agreement) that has been filed and approved by the Department.
2. The Plan does not employ/contract staff with sufficient accounting skills and an adequate knowledge of Generally Accepted Accounting Principles ("GAAP") to prepare adequate interim financial statements in accordance with GAAP, as required by Section 1345(s). Our examination disclosed many deficiencies in the financial statements and supporting records. This is evidenced by the number of adjusting journal entries and reclassifying journal entries presented in Section I. of this report, which include adjustments resulting from the Plan's previous audit for the year ended December 31, 2001. [See related comments in Section IV. C. of this report.]
3. The Plan substantially overstated its TNE position in its financial statements filing with the Department for the month ended August 31, 2002. The Plan reported excess TNE of \$27,491. The proper TNE position was not evident until the examination adjustments were made resulting in a TNE deficiency of <\$246,343>. [See Section I. and Section II. of this report]. The reason for this overstatement is due to the financial statements not prepared in accordance with GAAP. In addition, the Plan substantially overstated its TNE position in its financial statement filing with the Department for the year ended December 31, 2001. The Plan reported excess TNE of \$36,609. However, the Plan failed to file annual DMHC financial statements that agreed with the annual audited financial report prepared by its independent auditors. The Plan should have reported a TNE deficiency of <\$127,193>.
4. Due to the Plan's failure to prepare its financial statements in accordance with GAAP and its failure to properly calculate its TNE position, it must be concluded that the Plan's executive staff is not performing adequate oversight of the functions performed by the CFO and Senior Accountant and does not maintain adequate written procedures to provide for effective controls over the Plan's operations.
5. The Department determined that hours spent by the CFO and Senior Account to perform the administrative functions of the Plan was not sufficient. The CFO was not at the Plan's location and was not in communication with the Department at any time during our examination. The Department was told that the CFO spends up to three hours a month and mainly supervises the Senior Accountant. The Senior Accountant spends approximately five hours a month on the Plan and he was not readily available during our examination. Although the Plan has a full-time bookkeeper, he has limited understating of the Plan's financial statements and nature of each account. During the bookkeeper's vacation, books and records could not made available to the Department. [See related comment in Section IV. F. of this report.]

6. The Plan's staff did not process claims in a manner that demonstrated substantial compliance with the requirements of Section 1371, 1371.35 and Rule 1300.77.4. [See related comments in Section IV. D. of this report.]
7. The Plan failed to comply with the filing requirements of Section 1352 and Rules 1300.52 and 1300.52.1. [See related comments in Section IV. B. of this report.]
8. The Plan made payments of interest on the subordinated debt held by the President and sole shareholder through August 31, 2002. The independent auditor's management report dated May 6, 2002 informed the Plan that since its TNE was below the minimum required for the year ended December 31, 2001 that it was not obligated to pay principal or interest on the subordinated debt. The Plan did not actually issue cash payments, but offset the payments of interest on subordinated debt against a receivable from the President that was incorrectly recorded in the trade payable account.
9. The Plan paid lease expenses for the Ontario office location on behalf of the President and sole shareholder. The President stated that this office space was donated to the Plan. The Plan offset the lease payments against the interest on subordinated debt owed to the President. These lease expenses were recorded as a "debit" in the trade payable account, instead of recorded as a receivable from the shareholder. The shareholder did provide infusions of cash, but not enough to fully reimburse the Plan for these lease payments at August 31, 2002.
10. The Bylaws attached to the January 2, 2001 Board of Director minutes are not complete.
11. The Board of Director's minutes did not demonstrate that the Board is discussing the financial transactions of the Plan or reviewing the financial statements. The minutes do not report the change in CFO from Ken Oliveira to Terence Milaney or the opening of an additional administrative office in Ontario. The minutes do not indicate that the CFO is attending the meetings.
12. The significant deficiencies noted in this report are also repeat deficiencies from the previous routine examination for the quarter ended July 31, 1998 as addressed in our Final Report dated October 1, 1999.

The Plan's failure to comply with the administrative capacity requirements of Section 1367(g) and Rule 1300.67.3 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the plan to provide a detailed Corrective Action Plan ("CAP") to bring the Plan in compliance with Section 1367(g) and Rule 1300.67.3(a)(2) and (3). The CAP was to include the following elements:

- ?? Administrative service agreements are to be entered into between the Plan and the consultants that provide services to the Plan. These agreements should be specific

regarding the services to be performed by the consultants. Each agreement must state how the Plan will provide oversight for each delegated activity and how the performance of this oversight will be documented. In addition, the compensation arrangements should be fully disclosed and the Plan is to demonstrate that the compensation is fair and reasonable to the Plan and relates to the services provided. Also, the Plan is required to identify the management position responsible for the oversight of the consultants.

- ?? A demonstration that the Plan has sufficient staffing in fiscal and administrative services and proper written procedures for the effective conduct of the Plan's business. Such corrective action is to include a detailed description of all controls and procedures implemented by Plan management. This demonstration is also to support that the CFO and Senior Accountant devote adequate time to perform their duties.
- ?? A demonstration that the Plan's executive and key management have adequate knowledge and understanding of the Act and Rules.
- ?? A demonstration that the Plan now has executive and key management, as well as support staff, with sufficient accounting skills and adequate knowledge of GAAP to ensure that the financial statements are prepared in accordance with GAAP.
- ?? A demonstration that the Plan has a Board of Directors that is actively involved in the financial and operational issues of the Plan.

The Preliminary Report required the Plan to provide a copy of the required administrative services agreements with its response to this report. The CAP provided in response was to address the examples cited above and provide time frames for compliance for any CAP that may take longer than the 45-day response time to this report. The Plan was to demonstrate full compliance no later than 90 days from the date of the Plan's receipt of the Preliminary report. Status reports are to be provided to the undersigned within 30 days, 60 days and 90 days for any CAP not completed in the Plan's initial response to the Preliminary Report.

The Plan included in its response a CAP in connection with the issues above. The following is a summary of the CAP:

- ?? *The Plan's President and CEO, and Board of Directors are responsible to ensure the Plan's compliance with the administrative capacity requirements. The Plan's Dental Director makes all decision with respect to dental care provided to Plan enrollees; and, reports to the Board of Directors and President of the Plan. The Dental Director is assisted by the Provider Director to ensure compliance with the administrative capacity requirements.*
- ?? *The Plan has retained a CFO and a Marketing Consultant and provided copies of their Administrative Services Agreements. The Plan stated that the compensation rates to be*

paid are believed to be fair and reasonable. The Plan President and CEO will monitor the performance of these agreements.

?? The Plan's Senior Accountant now reports to the new CFO. The CFO and Senior Accountant will provide as much time and training as required to ensure financial reporting is completed accurately and Plan operations comply with the Act and Rules, as well as GAAP.

?? The CFO will sit as a member of the Plan's Board of Directors. The CFO will report on financial issues, the progress of the Plan to correct past errors, and the progress made to reorganize the Plan's accounting operations.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required, as follows:

?? The Plan's response did not include a demonstration that it has proper written procedures for the effective conduct of the Plan's business. The CAP was to include a detailed description of all controls and procedures implemented by Plan management.

?? The Plan's response did not include a demonstration that it has a Board of Directors that is actively involved in the financial and operations issues of the Plan.

The Plan is again required to provide a corrective action plan that demonstrates compliance with the above bullet points.

The Department acknowledges that the Administrative Service Agreements for the CFO and Marketing Consultant were filed as amendments on July 8, 2003 and are currently under review.

**B. AMENDMENTS/MATERIAL MODIFICATION TO PLAN APPLICATION—Repeat
Deficiency**

Section 1352(a) and Rule 1300.52 require all plans to file an amendment with the director within thirty (30) days after any changes in the information contained in its application, other than financial or statistical information. Section 1352(b) and Rule 1300.52.1 requires all plans to file material changes to the plan's operations as a Notice of Material Modification prior to any changes being implemented. Rule 1300.52.4 sets forth standards for amendment and notices of material modification filings.

Our examination disclosed that the Plan failed to comply with the filing requirements of Section 1352 and Rules 1300.52, 1300.52.1 and 1300.52.4, as follows:

1. During additional fieldwork on February 6, 2003, the Department noted a cash receipt and payroll transaction dated in December 2002 occurred between the Plan and an entity named

3M Jaimini. The Department discussed the transaction with the Plan's President and was informed that the Plan acquired a controlling interest in a limited liability company ("LLC"). The Plan also disclosed that it modified its approved network of contracting providers through the addition of Plan-employed dental providers through a staff model dental office; implemented a Plan-provider employment contract; and the implemented a contract for the performance of administrative services for the Plan by the LLC.

The Plan filed an amendment with the Department on February 19, 2003, after the Department questioned the transaction during the fieldwork. However, this acquisition and the modifications constitute a material change to the Plan's operations, requiring the Plan to file a notice of material modification and obtain the Department's approval prior to implementation pursuant to Section 1352(b) and Rules 1300.52.1 and 1300.52.4(d)(vii). The Department issued a letter of disapproval on March 14, 2003.

The Plan illegally engaged in this transaction due to its failure to file this transaction as a Notice of Material Modification and due to its failure to obtain prior approval from the Department prior to implementation.

2. Our examination disclosed that the Plan opened an additional administrative office in Ontario, California on September 1, 2001 to conduct accounting and marketing functions. The Plan failed to file an amendment with the Department within 30 days after opening the new office.

The Plan filed an amendment on December 19, 2002, after the Department informed the Plan of its failure to file.

3. Our examination disclosed that the Plan hired a Director of Marketing in September 2001. The Plan failed to file an amendment with the Department for the addition of this principal officer, as required by Rule 1300.52.2.

The Plan's failure to comply with the filing requirement for a change in personnel pursuant to Section 1352 and Rule 1300.52.2 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

4. Our examination disclosed that the Chief Financial Officer and Senior Accountant perform accounting functions as consultants to the Plan without benefit of a written contract for these services. Rule 1300.51(d)(N) requires a plan to file a contract for consulting services. The Plan failed to enter into or file contracts for these consulting services as an amendment with the Department within 30 days after entering into these arrangements.

The Plan's failure to file the amendments referenced in paragraphs 2 through 4 above, are a violation of the requirements of Section 1352(a) and Rules 1300.51, 1300.52, 1300.52.2 and 1300.52.4.

The Preliminary Report required the Plan to state the policies and procedures developed to ensure that the Plan will comply with the requirements of the above Section and Rules. The Plan was required to state the date these policies and procedures were implemented and identify the management position responsible for ensuring this corrective action was implemented for ongoing compliance.

The Plan responded that it has retained the law firm of Wilke, Fleury, Hoffelt, Gould and Birney, LLP, and specifically, Michael Polis, to advise the Plan relative to compliance issues. The firm's attorney's are versed in compliance with the Knox-Keene Act and represent a number of full and specialty health care service plans and will provide counsel on all legal matters related to the Plan operations. The Plan further represented that Mr. Polis will attend all quarterly board meetings, provide reports to the board relative to corporate compliance and address the board's concerns relative to legal and regulatory compliance issues.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The Plan did not state the policies and procedures developed to ensure that the Plan will comply with the requirements of the above Section and Rules. The Plan did not state the date these policies and procedures were implemented; nor, did it identify the management position responsible for ensuring this corrective action was implemented for ongoing compliance. The Plan is again required to provide this documentation.

C. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Section 1345(s) states that financial statements are to be prepared in accordance with generally accepted accounting principles (GAAP). Rule 1300.45 indicates that the Accounting Principles Board Opinions, Financial Accounting Standards Board Statements (FASB), accounting research bulletins and other authoritative pronouncements of the accounting profession should be applied in determining GAAP.

GAAP requires that financial statements be prepared on the accrual basis of accounting for fair presentation of an entity's financial position. The accrual basis of accounting is defined in Statement of Financial Accounting Concepts No. 6, paragraphs 139 to 141.

Rule 1300.84.3(d) and 1300.84.2(a) require that a plan's monthly and quarterly financial statements be prepared in accordance with GAAP, as well as be prepared on a basis consistent with the annual audit report furnished pursuant to Section 1384(c).

Our examination disclosed the following:

1. The examination adjustments presented in Section I. C. of this report were mostly the result of the Plan's failure to properly accrue assets and liabilities or its failure to match revenue and expenses in accordance with GAAP. Some examples are described below:

- ?? The balance reported by the Plan for Furniture & Equipment was overstated and not supported by a subsidiary schedule or other documentation. The balance reported by the Plan for Intangible Assets was understated by the same amount. The misstatement of these two accounts was due to the unsupported allocation of the purchased price paid for of Healthdent for Furniture & Equipment and Intangible Assets and the Plan's failure to record the audit adjustments recommended by the independent auditors for the year ended December 31, 2001 to fairly state these accounts.
- ?? The balance reported by the Plan for Prepaid Expenses included assessment fees paid to the Department for previous years that should have been fully amortized. The Plan failed to properly amortize these expenses over the time periods to which the assessment fees relate.
- ?? The Plan reported premium revenue on a cash basis for several of its benefit products. GAAP requires that revenue be recognized when it is earned and expenses recognized in the period incurred, without regard to the time of receipt or payment of cash. The Plan overstated its premium revenue and understated its liabilities due to its failure to defer the recognition of premium revenues received for service dates not yet incurred.
- ?? The Plan reported the prepayment of annualized capitation expense to its providers under the PrimeCare product on a cash basis. The Plan recognized capitation expense for the entire year when the capitation checks were issued, instead of recording a prepaid expense for the capitation paid for service dates not yet incurred as required by GAAP. As a result, the Plan understated its assets and overstated its medical expenses. The Department determined that the Plan does not maintain supporting records to track the dates of service months with the capitation payments.
- ?? SOP 98-5 states that start-up costs, including organizational costs, should be expensed when incurred. The Plan capitalized legal fees related to the January 1, 2001 purchase of Healthdent with an amortization period over five-years and reported as Organization Costs. The independent auditors expensed these start-up costs in the audited financial statements for the year ended December 31, 2001. However, the Plan failed to record this audit adjustment, resulting in an overstatement of Intangible Assets.
2. The President and sole shareholder of the Plan stated that he is donating office space at the Ontario location to the Plan. The Plan paid lease expenses for the Ontario office location on behalf of the President and then offsets these lease payments against the interest on subordinated debt owed to the President. The Plan has failed to properly disclose donated services in the footnotes to its financial statements. GAAP requires the value of donated services to be disclosed.

The Preliminary Report required the Plan to provide a CAP that will ensure that the financial statements of the Plan will be prepared on the accrual basis of accounting and provide all disclosures as required by GAAP. This CAP was to include the following elements, as well as address the deficiencies cited above:

- ?? Measures implemented that will assure the accurate calculation and the proper financial statement presentation of all financial transactions in accordance with GAAP.
- ?? An accounting manual that provides a complete and detailed description of all controls and procedures to be implemented regarding the recording of all financial transaction cycles and general ledger accounts.

The Preliminary Report also required the Plan to state the date the CAP was implemented, identify the management position responsible for ensuring this corrective action was implemented and the monitoring procedures for ongoing compliance.

The Plan included in its response a CAP that sets forth the following:

- ?? In May 2003 a CFO was retained to provide expert accounting services to ensure the accurate reporting of the financial position, results of operations and changes in cash balances of the Plan. The CFO is to review the weekly financial "snap shot", monthly, quarterly and annual financial statements filed with the Department and other financial documents and information related to Plan operations.*
- ?? The CFO will develop and complete the accounting manual on or before July 15, 2003.*

The Department finds that the compliance effort described above is responsive to the corrective action required. The Plan is to confirm the date that the required accounting manual was completed and the date compliance with the accounting manual was implemented. The Plan is to provide a hardcopy copy with its response to this report.

D. CLAIMS—Repeat Deficiency

Section 1371 requires a specialized health care service plan to reimburse claims within thirty (30) working days after receipt of the claim, unless the claim is contested or denied by the plan. This section further states that if an uncontested claim is not reimbursed within the thirty (30) working day period, interest shall accrue at the rate of fifteen percent (15%) per annum beginning with the first calendar day following the thirty (30) working day period. A health care service plan shall automatically include in its payment of the claim all interest that has accrued pursuant to this section without requiring the claimant to submit a request for the interest amount. Any plan failing to comply with this requirement shall pay the claimant a ten-dollar (\$10) fee.

Section 1371.35, which refers to claims resulting from emergency services, requires that if an uncontested claim is not reimbursed within thirty (30) working days after receipt, the plan shall automatically include in its payment of the claim the greater of \$15.00 per year or interest at the rate of 15 percent per annum, beginning with the first calendar day after the thirty (30) working day period.

Rule 1300.77.4 requires all plans to institute procedures whereby all claims can be tracked and accounted for from the date received until they are fully resolved. This system must allow for the determination of the date of receipt of any claim, the status of the claims, the dollar amount of unpaid claims at any time and for the rapid retrieval of any claim.

Although the Plan is primarily a capitated network operation, the Plan does receive a limited number of claims from a provider or enrollee. The Plan provides payment of \$50 to an enrollee for emergency treatment and some benefit packages provide for payment of \$50 for a specialist consultation.

When these claims are received by the Plan they are processed through the Plan's trade accounts payable system. The Plan does not separately monitor or report claims payable. The Plan does not track claims as required by Rule 1300.77.4. Therefore, the Department's review of claims was limited.

Our examination disclosed that:

- ?? The Plan paid 6 out of approximately 50 claims, reviewed for the period May through November 2002, beyond the thirty (30) working day timeframe. These claims were paid from 19 to 45 days late.
- ?? The Plan did not pay interest or fees on these late claims, as the Plan has no written policies or procedures to pay interest or the required fees on late claims.
- ?? The Plan cannot determine the status of claims as required by Rule 1300.77.4. The Plan did not date-stamp claims with date of receipt. In some cases, the Plan entered the receipt date on a separate form attached to the claim. As a result, the Department was unable to determine whether all the claims in the sample reviewed were paid in compliance with Section 1371 or 1371.35.

Due to the Plan's lack of a formal claim processing system, the Department was unable to determine any resulting liability for unpaid interest and fees for the period ended August 31, 2002.

The Plan's failure to comply with the claims payment requirements of Sections 1371 and 1371.35 and the tracking of claim status pursuant to Rule 1300.77.4 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to provide evidence of the corrective action taken that includes the following:

- ?? Written policies and procedures to demonstrate compliance with Section 1371 and 1371.35.
- ?? Provide for the identification of all claims paid after thirty (30) working days from the date of receipt for the period of January 1, 2001 through the implementation date of the new policies and procedures. The Plan is required to indicate the implementation date of the new policies and procedures.
- ?? Demonstrate that interest and fees, as appropriate, were paid retroactively on these late claims.
- ?? Written policies and procedures to demonstrate compliance with Rule 1300.77.4.

In addition, the Preliminary Report required the Plan to describe the controls implemented to ensure compliance with Section 1371, 1371.35 and Rule 1300.77.4, and identify the management position(s) responsible for ensuring ongoing compliance.

The Plan's response included a CAP that sets forth the following:

- ?? *The Plan represents it implemented policies and procedures to ensure claims are paid within thirty days from the date received by the Plan. The Plan stated that on a daily basis, the Plan's Member Services Manager date stamps all claims received by the Plan. Within three days of receipt of the claim, the Provider Relations Manager reviews the claim and determines the correctness. If the claim is "clean", then the claim goes to the accounting manager for immediate payment. If the claim is not "clean", then a letter is immediately sent to the claimant explaining the reason why the claim cannot be paid.*
- ?? *The Plan represented that the CFO will develop policies and procedures with respect to claim payment process by July 15, 2003. The Plan stated that based on the current plan design, the Plan pays fewer than a dozen claims a year.*
- ?? *The Plan's Provider Relations Manager is ensuring that interest and late fees are reimbursed to claimants who are entitled to payment within thirty days from receipt, but the Plan failed to pay. The Plan stated that payments are to be made by June 30, 2003.*

The Department finds that the compliance effort described above is not fully responsive to the corrective action required.

The Plan is to confirm the date that the written policy and procedures were completed to demonstrate compliance with Section 1371 and 1371.35 and Rule 1300.77.4. The Plan is to provide a copy of these policy and procedures with its response to this report.

The Plan response did not provide the identification of all claims paid after thirty working days from the date of receipt for the period of January 1, 2001 through the implementation date of the new policies and procedures. The Plan's response did not demonstrate that interest and fees, as appropriate, were paid retroactively on these late claims. The Plan is required to provide a copy of a report that identifies each late claim as follows:

1. provider or enrollee (using non-confidential information)
2. claim number
3. date of original receipt
4. date claim was originally paid
5. amount paid
6. number of days late
7. amount of interest due
8. late fee due
9. total interest and fee paid
10. check number
11. check issue date
12. date check cleared the bank

This report should also provide the aggregate total of all interest and fees paid on these late claims.

The Plan's response did not clearly identify the controls implemented to ensure compliance with Sections 1371, 1371.35 and Rule 1300.77.4 or the management position(s) responsible for ensuring ongoing compliance. The Plan is again required to provide this information.

E. FIDELITY BOND—*Repeat Deficiency*

Rule 1300.76.3(a) requires that each plan shall at all times maintain a fidelity bond covering each officer, director, trustee, partner, and employee of the plan, whether or not they are compensated. The fidelity bond shall also provide for thirty (30) days' notice to the Director prior to cancellation.

The fidelity bond presented for our review did not include an endorsement stating that the bond provides coverage to each officer, director, trustee, partner and employee of the Plan, whether or not they are compensated; nor, did it include a provision for 30 days' notice to the Director prior to cancellation.

The Plan's failure to comply with the fidelity bond requirements of Rule 1300.76.3 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to provide a copy of a fidelity bond that contains the necessary endorsements to demonstrate compliance with Rule 1300.76.3. The Plan was also required to state the management position responsible for ensuring this corrective action and to provide a description of the monitoring system implemented to ensure ongoing compliance.

The Plan's response included a copy of the endorsement to the fidelity bond to demonstrate compliance with Rule 1300.76.3. The Plan stated that it's President and CEO is responsible to ensure that the fidelity bond contains all the required endorsements.

The Department finds that the compliance effort described above is responsive to the corrective action required. However, the Plan is required to have the endorsement regarding the cancellation notice to the Department expanded to site the Director of the Department of Managed Health Care at the Sacramento address.

F. BOOKS AND RECORDS—Repeat Deficiency

Section 1381(a) states that all records, books, and papers of a plan, management company, solicitor, solicitor firm, and any provider or subcontractor providing health care or other services to a plan, management company, solicitor, or solicitor firm shall be open to inspection during normal business hours by the director.

Rule 1300.85 requires that each plan maintain its books of account and other records on a current basis. This Rule also sets forth that a plan shall retain certain books and records of which one element is to accurately reflect all contracts entered into by the plan.

Rule 1300.85.1 requires that the Plan shall preserve the books of account and other records for at least five years, the last two years of which shall be in an easily accessible place at the offices of the Plan. After two years, the books and records may be warehoused or stored, or microfilmed, subject to their availability to the Director within not more than 5 days after a request.

Our examination disclosed the following deficiencies:

1. The general ledger was not maintained on a current basis, as the adjusting journal entries recommended by the independent auditors for the year ended December 31, 2001 were not posted as of February 28, 2003.
2. The general ledger was not maintained on a current basis, as the Plan failed to accrue for legal and audit fees that were provided prior to August 31, 2002.

3. Books and records were not available to the Department during normal business hours while the Accountant was on vacation in mid-January through early February 2003.
4. Amendments to provider contracts to reflect changes in compensation schedules were not executed by the provider. [See related comments in Section IV. G. of this report.]
5. Check copies for 14 cancelled checks issued during the period October 1 to December 31, 2002 were not located.
6. Five checks were not posted to the general ledger in the period they were written, but in the following month. Manual checks issued by the Chief Operating Officer in the Plan's Sacramento office are mailed to the bookkeeper in the Plan's Ontario office for posting to the general ledger. This process creates a lag between the check issued date and the general ledger post date.

The Plan's failure to comply with the books and records requirements of Section 1381 and Rules 1300.85 and 1300.85.1 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to state the corrective actions taken to ensure compliance with Section 1381 and Rules 1300.85 and 1300.85.1. The Plan was also required to state the date this corrective action was implemented and identify the management position responsible for ensuring this corrective action was implemented and is monitoring for ongoing compliance.

The Plan responded that its books and records have been and remain available to the Department's staff. The Plan stated that its CEO and President is responsible to ensure that the Plan's books and records are available for review during normal business hours by the Director. The Plan implemented this action on June 1, 2003, when it moved its operation from Sacramento to Ontario, California.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The Plan's response did not expand on its statement that "...books and records have been and remain available..." and how this statement relates to the Department's examples of books and records not being current or not provided for review during the examination. The Plan is required to expand on its response and set forth the corrective actions taken to ensure compliance with the above Section and Rules.

G. PROVIDER CONTRACTS

Rule 1300.67.8 requires written contracts to be executed between the Plan and each provider of health care services, which regularly furnishes services under the Plan. The contract must be

prepared in a manner, which permits confidential treatment by the director of payment rendered or to be rendered to the provider without concealment or misunderstanding of other terms and provisions of the contract.

The contracts between the Plan and the providers under the PrimeCare product provide that the capitation payments are due and payable on the 20th day of the month following the month in which premiums were collected. However, our examination disclosed the Plan has failed to comply with these payment arrangements. The providers under the PrimeCare product were not paid for July and August 2002 dates of service until October 2002. As of January 31, 2003, the Plan had accrued a liability but failed to pay these providers capitation for September, October, November and December 2002 months of service.

The compensation rates in the contracts between the Plan and the providers under both the PrimeCare product and Healthdent product were amended during 2002. Executed amendments were not provided for the sample of providers selected during our examination. In addition, the Plan does not pay the providers in accordance with the rates for the Healthdent product as presented in the amendment.

The Plan did not file these amended compensation schedules with the Department.

The Preliminary Report required the Plan to review all current provider contracts and file with the Department all contracts that were amended to disclose the capitation payment arrangements. A sample of a revised or amended contract for each capitation arrangement must be filed as an amendment filing with the Department. The amendment should include a detailed description of the compensation arrangements and demonstrate that they comply with the Act and Rules. The Plan was also requested to provide a copy of this amendment filing made with the Department within forty-five (45) days after receipt of this report. The cover page for this amendment filing should state that it is filed as a result of the recent financial examination.

In addition, the Preliminary Report required the Plan to provide a written assurance regarding the timeframe for ensuring that all providers enter into and execute a revised or amended contract, as filed and approved by the Department.

The Preliminary Report also required the Plan to explain the corrective action taken to ensure that the providers are now correctly compensated for the Healthdent product. The Plan was required to review all provider payments for the Healthdent product and retroactively pay any differences between the rate paid and the amended contract rate, back to the date of the amendment. The Plan was required to provide evidence of the calculation of the retroactive compensation owed to the providers and the date this additional compensation was paid.

Furthermore, the Plan was required to identify the management position responsible for ensuring compliance and the controls implemented to ensure ongoing compliance.

The Plan responded that it reviewed all of its current provider contracts and determined that all provider contracts in use have been filed with the Department. The Plan's response included a copy of a letter sent to its Healthdent providers in September 2002 for changes in compensation. to be effective October 2002. The Plan stated that this compensation arrangement, adopted in October 2002, would be filed with the Department by June 30, 2003.

The Plan further responded that it mailed to its providers in September of 2002 a revised provider contract that essentially changed the method of compensation. The Plan further stated that it inadvertently, failed to file that document with the Department. The Plan intends to file the amendment with the Department by June 30, 2003.

The Plan stated that for the months of August and September of 2002, the Plan incorrectly compensated a percentage of its providers the wrong amount for the care provided. In August of 2002, the Plan stated it revised the method it compensates its providers. In September of 2002, the Plan stated it informed its providers by letter of the change. The Plan represented that it would take immediate corrective action to pay the providers their correct compensation. The Plan stated that it's Provider Relations Manager would review all providers payments made in the months of August and September of 2002 and compare the amount owed each provider pursuant to the contract to the amount actually paid each provider. The Plan stated that it intends to complete this task by June 30, 2003, and mail the checks to those impacted by this error by July 1, 2003.

The Plan stated that it's CEO and President is responsible to ensure compliance with respect to paying providers the correct compensation.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required.

The Plan did not file the amended provider contracts with the Department by June 30, 2003 as stated in its response. The Plan is again required to comply with this request.

The Plan did not provide evidence of the calculation of the retroactive compensation owed to the providers for the Healthdent product; or, evidence of the date of payment. The Plan responded that it would complete its review of provider payments by June 30, 2003 and mail the checks by July 1, 2003. The Plan is again required to comply with this request. Such evidence should include a report that identifies the following:

- 1. provider (using non-confidential information)**
- 2. date of original capitation payment**
- 3. amount paid**
- 4. calculation of correct capitation payment**
- 5. amount of additional capitation due**
- 6. check number**
- 7. check issue date**
- 8. date check cleared the bank, if available**

The Plan is also required to provide written confirmation that the capitation payments to the providers for the PrimeCare product comply with the contractual payment arrangements and that capitation payments are now current through June 2003 date of service.

H. ADMINISTRATIVE COSTS—*Repeat Deficiency*

Rule 1300.78(b) requires that administrative costs incurred by the Plan must be reasonable and necessary. This Rule indicates that if administrative costs of a Plan that has been in operation for five years or more, exceed 15% of subscriber revenue, or if the administrative costs of a plan in the development phase exceed 25%, the plan shall demonstrate to the Director, if called upon to do so, that its administrative costs are not excessive administrative costs within the meaning of Section 1378 and are justified under the circumstances and/or that it has instituted procedures to reduce administrative costs which are proving effective.

Revenues from subscribers and enrollees for eight months ended
August 31, 2002, as adjusted by examination findings from Section
I.B

\$ 529,394

Administrative Costs for eight months ended August 31, 2002, as
adjusted by examination findings from Section I.B

\$ 415,753

Administrative Cost percentage as of August 31, 2002

78.5 %

Our review of administrative costs was performed for the eight months ended August 31, 2002, after examination adjustments, and resulted in administrative costs being 78.5% of subscriber revenue. The administrative cost percentage was higher than historically reported by the Plan due to our examination adjustments to properly record deferred revenue. [See Section I. C. of this report.] The Plan reported administrative cost percentage of 66% at year ended December 31, 2001 and 78% for quarter ended December 31, 2002.

During our examination, the Plan provided a justification to support the Plan's administrative costs reported in their historical quarterly reports filed with the Department for January 31, 2002 through June 30, 2002, which ranged from 47.2% to 60.3%. However, the Department determined that this justification did not adequately identify the specific actions or procedures instituted by the Plan to reduce administrative costs.

The Plan's failure to comply with the administrative cost requirements of Section 1378 and Rule 1300.78 was previously reported in the Department's Confidential Report of Examination dated October 1, 1999, for the period ended July 31, 1998.

The Preliminary Report required the Plan to provide a written statement as to the procedures or actions instituted to reduce administrative costs that are proving effective. The Plan was also

required to state the date of implementation and the management position responsible for monitoring compliance with these procedures to ensure ongoing compliance.

The Plan responded that it has taken significant strides in reducing its administrative overhead burden, but remain compliant (or become compliant) with the requirements of the Act and Rules. As stated in other responses of this report, the Plan represented that it has reduced duplicative staff positions, closed its Sacramento office and cut back on unnecessary expenditures. The Plan stated that it's President and CEO is responsible for all Plan operations, including compliance with monitoring administrative costs and all other expenditures.

The Department finds that the compliance effort described above is responsive to the corrective action required. However, in reviewing the projections filed with the Plan's response, the Department noted that projected dental service costs (i.e., medical costs) include commission paid to the dentists. The Plan is required to confirm that all costs associated with the solicitation of subscribers and enrollees are considered administrative costs pursuant to Rule 1300.78 and are properly reported as an administrative cost in all financial statement filings made with the Department, beginning with the monthly report for June 30, 2003.

I. FINANCIAL STATEMENT PRESENTATION

Rule 1300.84.2 sets forth the requirements for the filing of quarterly financial statements with the Department. This rule also refers to Rule 1300.84.06(b) that sets forth the requirements for the supplemental information that is to accompany the filings made in the Department's report format.

Our examination included a review of the supplemental information accompanying the Plan's quarterly filings for June 30, 2002 through December 31, 2002; and, included a review of the financial presentation for the month ended August 31, 2002. The following concerns were noted:

- ?? The supplemental information form is not completed for items A through D for the quarterly reports. Although the Plan does not meet the requirements for reporting incurred and unreported claims, the Plan should state in item A that it is not applicable. Our examination disclosed that the Plan has transactions with its President and sole shareholder that result in accounts receivable and donated services that are to be disclosed in items B and C. If item D is not applicable, then the Plan should so state. [See related comments in Section IV.A. of this report.]
- ?? The Plan does not separately report claims payable in the liability section of its financial reports.
- ?? The reclassification entries presented in Section I. C. of this report disclose accounts that were not reported on the appropriate line item in the financial reports.

?? The enrollment of 15,689 as presented in Report #4 of the Plan's quarterly report for June 30, 2002 was not supported by the Plan's enrollment data of 13,450. The enrollment of 15,016 as presented in Report #4 of the Plan's monthly report for August 31, 2002 was not supported by the enrollment data of 12,908.

The Preliminary Report required the Plan to state the corrective action taken to ensure that compliance with the above concerns is demonstrated in the quarterly financial statement for March 31, 2003 due to be filed on May 15, 2003. The Plan was required to demonstrate that it has an enrollment tracking system in place that will ensure reliable enrollment information is received and maintained. The Plan was also required to demonstrate that it complies with the requirements of Rule 1300.85(b)(1).

Furthermore, the Plan was required to state the date the corrective action was implemented, identify the management position responsible for compliance and the controls implemented for monitoring continued compliance.

The Plan represented in its response that it corrected the errors associated with its enrollment tracking process on May 1, 2003. The Plan stated that it now generates each month the "Member Coverage Roster." The Member Coverage Roster is a report that tracks in detail the enrollment of the Plan. For example, the report lists the name of all subscribers and enrollees, home/business address, plan selection, and assigned provider. The Member Coverage Roster is reviewed by the Member Services Manager, who is assigned the task of ensuring its accuracy by updating each month the additions and deletions of enrollment. The enrollment information is then provided to the CFO for inclusion on the DMHC Reporting Format. The Plan stated that the CFO confirms the enrollment number is correct by reviewing the Member Cover Roster. If errors are detected, the CFO consults with the Members Services Manager to determine the reason for the error(s) and the best method to correct the problem(s).

The Department finds that the compliance effort described above is not fully responsive to the corrective action required.

The Plan did not provide a response as to the corrective action taken to ensure compliance with the deficiencies cited in the financial statement filings required, beginning with the quarterly report for March 31, 2003. The Department's review of the quarterly report for March 31, 2003 filed on May 15, 2003 finds that the Plan did not correct the deficiencies noted for proper completion of the supplemental information form. The Plan did not separately report claims payable in the liability section of the report. The Plan did not properly report capitation payments on line 2 of the liability section of the report. In addition, the Plan incorrectly reported Premium Revenue as Capitation Revenue in the Income Statement. In review of the Plan's monthly report for May 31, 2003 filed on July 8, 2003, the Plan correctly presents the capitation payments and premium revenue. The Plan is again required to properly complete the supplemental information and separately report claims payable in the liability section of the reports, beginning with the quarterly report for September 30, 2003 due to the Department on November 15, 2003. The Plan is also

required to state the date the corrective action was implemented and identify the management position responsible for compliance and the controls implemented for monitoring continued compliance with the financial reporting presentation.

Section V. INTERNAL CONTROL

Section 1384, 1345 (s), and Rule 1300.45(q) include requirements for filing financial statements in accordance with GAAP and other authoritative pronouncements of the accounting profession.

Statement on Auditing Standards (SAS) No. 78 states “Internal control is a process---effected by an entity’s board of directors, management, and other personnel--designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulation.”

SAS No. 60 requires an auditor to communicate reportable conditions noted during the examination to appropriate personnel. Reportable conditions involve matters coming to the auditor’s attention relating to significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organizations ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Our examination disclosed the following weaknesses in the Plan’s internal control structure:

- ?? The bank reconciliations do not indicate who prepared them and do not demonstrate that key management has performed a secondary review.
- ?? The Plan does not maintain subsidiary schedules to support fixed assets and does not perform routine reconciliations to supporting documentation.
- ?? The Plan accountant prepares journal entries, bank reconciliations, initiates check requests for invoices, and issues checks without documented prior approval from key management. These are incompatible duties assigned to one employee.
- ?? The Plan does not maintain written policies and procedures for each accounting function to ensure that adequate safeguards and separation of duties are in place.

The Preliminary Report required the Plan to state the corrective action implemented to correct the above deficiencies, the date of implementation, the management position responsible for compliance and the controls implemented for monitoring continued compliance.

The Plan's response stated that in June 2003, the plan retained Eric Kalter, CPA, of Kalter and Company, primarily to "clean-up" the financial system problems noted in the Department's financial audit. The Plan further stated that Mr. Kalter's background; experience and proximity to the Plan are ideally suited to assist the Plan in connection to meeting its financial reporting/control needs. Mr. Kalter will provide as much time as necessary to ensure that the Plan's reporting is accurate and internal controls are in place and operating properly.

The Department finds that the compliance effort described above is not fully responsive to the corrective action required. The Plan did not state the corrective action implemented for the deficiencies cited by the Department nor the date of implementation. The Plan is again required to do so.

NONROUTINE EXAMINATION

Due to the seriousness of the above deficiencies, the Plan is advised that the Department will conduct a nonroutine examination, in accordance with Rule 1300.82.1, to verify representations made to the Department by the Plan in response to the Report. The cost of such examination shall be charged to the Plan in accordance with Section 1382(b).

No response is required to this Section.